United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-2048

To be argued by
STEPHEN GREINER

IN THE

United States Court of Appeals

For the Second Circuit

Docket No. 74-2048

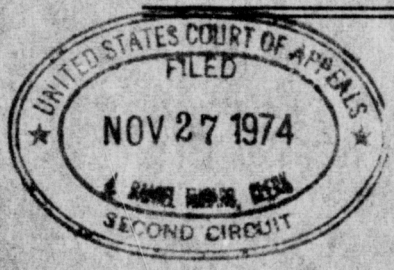
COMPETITIVE ASSOCIATES, INC.,
Appellant,

vs.

LAVENTHOL, KREKSTEIN, HORWATH & HORWATH, MORTON DEAR, ROBERT E. BIER and THOMAS MARTINO, JR.,
Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-APPELLEE LAVENTHOL KREKSTEIN HORWATH & HORWATH



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IN THE

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COMPETITIVE ASSOCIATES, INC.,

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BRIEF FOR DEFENDANT-APPELLEE LAVENTHOL KREKSTEIN HORWATH & HORWATH

Preliminary Statement

This is an appeal by plaintiff Competitive Associates, Inc. ("Competitive Associates") from a final judgment of the United States District Court for the Southern District of New York (Griesa, *J.*) ("District Court") entered on July 3, 1974 (203-204a)* in favor of defendants Laventhol Krekstein Horwath & Horwath ("LKH&H"), Morton Dear ("Dear"), Robert E. Bier ("Bier") and Thomas Martino, Jr. ("Martino"). The Opinion and Order of the District Court holding that the action must be dismissed against LKH&H, Dear, Bier and Martino (the "accounting defendants") is reported at CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,617 (S.D.N.Y. 1974) and reprinted in the Appendix at 188-202a.

* Unless otherwise indicated, all page references are to the appendix ("a") on this appeal.

The action is still pending in the District Court against the remaining defendants—Akiyoshi Yamada ("Yamada"), Takara Asset Management Corporation ("TAMC") and Ira N. Smith ("Smith").

Statement of Issues

There are four principal issues presented on the appeal of the judgment in favor of the accounting defendants:

1. Was the District Court correct in dismissing plaintiffs' federal securities law claims on the ground that the record established, beyond any genuine issue of fact, that plaintiffs had not been defrauded by the accounting defendants in the "offer or sale" or "in connection with the purchase or sale" of securities?

2. Was the District Court correct in dismissing plaintiffs' federal securities law claims on the ground that the record established, beyond any genuine issue of fact, that in hiring Yamada plaintiffs had not relied upon financial statements certified by LKH&H?

3. Was the District Court correct in dismissing plaintiffs' state law claims in view of (a) the dismissal of plaintiffs' federal claims and (b) the deficiency of the state claims by reason of plaintiffs' lack of reliance?

4. Was the District Court correct in granting summary judgment against plaintiffs in view of the fact that their submission failed to set forth any specific facts showing that there is a genuine issue of material fact for trial?

Statement of the Case

The Complaint

Plaintiffs Competitive Capital Corporation * ("Competitive Capital") and Competitive Associates instituted this action on May 9, 1972. (3a.) The parties to the action are identified in the complaint as being the following during all pertinent times: Competitive Capital is a registered investment advisor under the Investment Advisors Act of 1940 and the fund manager for Competitive Associates; Competitive Associates is a management open-end investment company registered with the Securities and Exchange Commission pursuant to Section 8 of the Investment Company Act of 1940; defendant Yamada is an individual residing in New York; defendant LKH&H is a firm of public accountants; defendant Dear is a partner of LKH&H and defendants Bier and Martino are employees of LKH&H; TAMC is a portfolio management company which managed a portion of the portfolio of Competitive Associates during the period from October 1970 through May 1971; defendant Smith is a partner in the law firm of Feiner, Curtis, Smith & Goldman. (11-13a.)

The complaint contains five unnumbered counts. Only the first two counts, comprised of paragraphs 11 through 16, purport to allege claims against LKH&H and the other accounting defendants. The first count alleges, *inter alia*, that:

> "In *early 1971*, Defendants Yamada, Laventhol, Dear, Bier and Martino singly and in concert, directly and indirectly in connection with the purchase and sale of securities *disseminated or caused to be disseminated to Competitive Capital and Competitive Associates* financial statements for Takara Partners, a limited partnership organized under the

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* Competitive Capital Corporation did not appeal the dismissal of the complaint as to it.

> laws of New York for the purpose of investing in securities, of which Defendant Yamada was a general partner, which financial statements were certified by Defendant Laventhol, and which included an income statement for the period from July 16, 1969 (inception) to December 31, 1969 and a balance sheet as of December 31, 1969. . . .''* (Emphasis added.) (13a.)

The complaint then sets forth, in some detail, certain of the representations contained in the certified financial statements and the respects in which those representations are alleged to have been false and misleading. (13-15a.) The first count ends—as it began—with a totally conclusory allegation (paragraph 14), that, by reason of the activities described, defendants Yamada, LKH&H, Dear, Bier and Martino violated Section 17(a) of the Securities Act of 1933 (''1933 Act''), 15 U.S.C. § 77(a), Section 10(b) of the Securities Exchange Act of 1934 (''1934 Act''), 15 U.S.C. § 78j(b), Rule 10b-5 of the Securities and Exchange Commission (''SEC'') promulgated thereunder (''Rule 10b-5''), 17 C.F.R. 240.10b-5, and Sections 206(1) and (2) of the Investment Advisors Act of 1940 (''Advisors Act''), 15 U.S.C. §§ 80b-6(1) and 80b-6(2).** Competitive Capital and Competitive Associates are alleged to have suffered damages in the aggregate amount of $6,000,000. (15a.)

The second count repeats the allegations of the first and alleges that, by reason of such alleged facts, the de-

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* The financial statements for Takara Partners which were certified by LKH&H and are referred to in paragraph 11 of the complaint are sometimes hereinafter referred to as the "certified financial statements." A true and complete copy of the certified financial statements appears at pages 67-81a of the Appendix.

** It should be noted that the complaint alleges (13a)—and the record indicates (57a)—only that LKH&H acted as accountants for Takara Partners, not that LKH&H served as "Yamada's accountants," as appellant charges. [Brief for Appellant Competitive Associates, Inc. ("App. Br."), p. 2.]

fendants have "breached their fiduciary obligations toward and have perpetrated a fraud on Competitive Capital and Competitive Associates." (16a.)

The third count purports to allege a claim under various provisions of the federal securities laws—but only against defendants Yamada and TAMC. It alleges, in substance, that in or about June 1970 defendants Yamada and TAMC, in an effort to obtain employment as manager of the investment activities of Competitive Associates, made certain false and misleading representations to Competitive Capital and to Competitive Associates concerning the financial condition and recent success of Takara Partners and of an entity known as Armstrong Investors.* Specifically, it is alleged that Yamada and TAMC made the following false representations: (1) that Takara Partners had $6,000,000 in assets and that its net asset value had increased by 14.3% in 1969; and (2) that Armstrong Investors had assets in excess of $8,000,000 and its net asset value had increased 8.5% during the period March through June 1970. It is further alleged that as a result of the representations specified in the third count, Yamada and TAMC were employed to manage a portion of the assets of Competitive Associates and during the period from October 1970 through May 1971 caused Competitive Associates to sustain losses in its portfolio amounting to $5,000,000." (16-18a.)

The fourth count purports to allege a claim only against Yamada, TAMC and Smith. It alleges, in substance, that during the period January 1971 through May 1971, said defendants, in violation of various provisions of the federal securities laws, concealed certain information from Competitive Associates, apparently so that Yamada would continue to be retained as portfolio manager for Competitive Associates. (18-19a.) The fifth and last count repeats the

* Although not identified in the complaint, Armstrong Investors, S. A., according to Yamada, was an offshore fund managed by Yamada. (66a.)

allegations of the fourth count and alleges that, by reason of those allegations, Yamada, TAMC and Smith are guilty of breaching their fiduciary duties to plaintiffs and of fraud. (19a.)

The accounting defendants, in their answers, deny the material allegations of the complaint.

The Summary Judgment Motion of LKH&H

On February 27, 1974—almost two years after the action was instituted—LKH&H moved pursuant to Fed. R. Civ. P. 56, for summary judgment dismissing the complaint as to LKH&H on the ground that there was no genuine issue as to any material fact and that LKH&H was entitled to judgment as a matter of law. (48-49a.) The principal basis for the motion was that discovery conducted in the action had established that, contrary to the allegations of the complaint, the certified financial statements of Takara Partners had not been seen by the plaintiffs, or any of their agents, until May 10, 1971, four days before Yamada was terminated as portfolio manager for Competitive Associates, and that hence, as a matter of law, plaintiffs' claim against LKH&H was deficient. (38a; 56-59a; 148a.)

The evidentiary material submitted in support of the motion consisted of two affidavits of Michael Lesch ("Lesch")—a member of the firm of Shea Gould Climenko & Kramer, then attorneys for LKH&H—and certain exhibits attached thereto which were the product of discovery. (50-81a; 132-187a.) Basically, the Lesch affidavits reviewed the facts as disclosed by the discovery proceedings. Those facts were derived entirely from (1) the deposition testimony of Alan R. Markizon ("Markizon"), an officer of both plaintiffs, which was taken by LKH&H (and certain exhibits marked for identification at that deposition), (2) the testimony of J. Robert Randolph ("Randolph"), president of both plaintiffs at all relevant times, given on May 10, 1971, in certain proceedings before

the SEC (and certain exhibits shown to Mr. Randolph during such testimony) and (3) plaintiffs' answers, sworn to September 25, 1973 by Mr. Markizon, to the interrogatories of LKH&H. (53-54a.)

All factual assertions set forth in the Lesch affidavits were documented by transcript page and exhibit references. Also contained in the Lesch affidavits was an offer to submit complete copies of the transcripts and of the exhibits if plaintiffs disputed the propriety or accuracy of any factual references or if the Court requested. (54a.) In addition, contained in the body of the Lesch affidavits or annexed as exhibits were portions of the transcripts of the testimony of Messrs. Markizon and Randolph and other documents which were considered to be of substantial importance.

In contrast to the substantial evidentiary showing made by LKH&H, plaintiffs submitted only a four-page affidavit of S. Pitkin Marshall, the attorney representing plaintiffs in the litigation, who did not purport to have personal knowledge of the matters at issue. (92-95a.) Submitted as exhibits to the Marshall affidavit were (1) certain pages of the deposition of Mr. Markizon taken by defendant Ira N. Smith and four additional pages of the Markizon deposition taken by LKH&H, (2) page 33 of the testimony of Mr. Randolph before the SEC, (3) a three-page document purporting to be a list of the general and limited partners of Takara Partners, which list plaintiffs claim was attached to a letter,* dated June 12, 1970, from Yamada to Randolph that was an exhibit to one of the Lesch affidavits (66a) and (4) counts 30 and 31 of the complaint in an action entitled *SEC* v. *Everest Management Corp. et al.*** (96-128a.) It

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* Mr. Markizon testified that he had not seen this letter and the list of partners until after Yamada was terminated. (127a.)

** Whatever plaintiffs viewed as the relevance of the portions of the complaint submitted, it is clear that the complaint was not competent material in the present litigation and could not affect the summary judgment motion.

is apparent from a review of plaintiffs' submission that the facts on which LKH&H relied upon its motion were almost entirely undisputed. In short, plaintiffs failed to submit any affidavit, deposition testimony or other competent evidentiary material containing facts, or from which inferences could be drawn, disputing the facts relied upon by LKH&H.

Rather than meeting facts with facts which, as we will demonstrate, is the only appropriate way of raising genuine issues of material fact under Fed. R. Civ. P. 56, plaintiffs' attorneys, in their memoranda of law,* posed various hypothetical factual possibilities. Despite the fact that such theories had not even been pleaded, plaintiffs argued that the theories, if they could be proved, would establish a claim against LKH&H. Plaintiffs did not submit any evidentiary support for the theories and, of almost equal significance, did not even request additional time under the provisions of Fed. R. Civ. P. 56(f) to muster that support. Instead, having posed hypothetical factual possibilities, plaintiffs argued—in much the same manner as appellant does on this appeal—that LKH&H had not negated those possibilities and therefore was not entitled to summary judgment.

On this record, the District Court granted summary judgment dismissing the complaint against the accounting defendants.

The Facts Established by the Record

The record reveals that there is no genuine issue as to any of the following facts: In 1970, Competitive Associates was an open-end mutual fund whose securities were selected for purchase and sale by portfolio managers. Competitive Capital was the fund manager for Competitive Associates and one of its functions was the selection of portfolio managers. (54a.) In or about April or May of

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* Plaintiffs' Memorandum of Law in Opposition to Defendants' Summary Judgment Motion, pp. 8-9; Plaintiffs' Answer to Reply Papers of LKH&H on Motion for Summary Judgment, p. 4.

1970, Competitive Capital decided that the portfolio managers for Competitive Associates ought to be changed. (54a; 106a; 152a.) Mr. Randolph was assigned the task of interviewing prospective portfolio managers and of recommending portfolio managers to the Board of Directors of Competitive Associates.* Randolph was the president of Competitive Capital from June 25, 1970 to June 30, 1972 and a member of its Board of Directors from April 14, 1971 to June 30, 1972. Randolph was also president and chairman of the Board of Directors of Competitive Associates from October 9, 1970 to June 30, 1972 and a member of its Board of Directors during that entire period. (35-37a.)

Yamada was one of the people whom Randolph interviewed as a prospective portfolio manager for Competitive Associates. (54a.) During his interview with Yamada, Randolph was told by Yamada that he managed Takara Partners, an investment partnership, and that he also managed an off-shore fund, Armstrong Investors. (54a.) In addition, Yamada gave Randolph a letter dated June 12, 1970, which set forth certain financial information concerning Takara Partners. Specifically, it stated that Takara Partners "was up 14.3% in 1969, and it is presently up 5.3% for 1970" and had assets of $6 million. The letter also stated that Yamada managed "Armstrong Investors S.A., an off-shore fund with assets in excess of $8 million." (96a.)

After receiving the June 12, 1970 letter from Yamada, Randolph prepared a write-up about him as well as about each of the other portfolio managers who was to be recommended to the Board of Directors of Competitive Associates. The write-ups contained certain biographical in-

* The evidence indicates that no one other than Mr. Randolph played any role in the interviewing, screening or recommendation of Mr. Yamada or other prospective portfolio managers. (54a; 56a; 60a.)

formation and the financial results which the portfolio managers had recently achieved. The write-up relating to Yamada, like Yamada's letter of June 12, 1970, stated that Takara Partners "was up 14.3% in 1969 and is presently up 5.3% for 1970" and that Takara Partners had $6,000,000 in assets. (55a; 109-110a; 141a; 161-162a.)

A meeting of the Board of Directors of Competitive Associates was held on June 25, 1970. At that time, two proposed portfolio managers for Competitive Associates, including Yamada, were recommended to the Board of Directors and were discussed. The write-up relating to Yamada, which Randolph had prepared, was presented to the Board at that meeting. (109-111a.) The source of the figures contained in that write-up was the letter of June 12, 1970 from Yamada to Randolph. (144a.) However, the source of the figures was not disclosed at the June 25 Board meeting and, in fact, no one asked for the source. (56a.) At the meeting of June 25, 1970, the Board of Directors of Competitive Associates approved the selection of Yamada as one of the portfolio managers. (55a.)

The certified financial statements were not presented or even referred to at the Board of Directors meeting of June 25, 1970, and, indeed, the name of LKH&H was not even mentioned at that time. (55-56a; 111a.) Importantly, a comparison of the figures contained in the certified financial statements with the Takara Partners financial information given to Randolph by Yamada, and thereafter presented to the Board in the Yamada write-up, shows that the figures are materially different.* (60-61a; 67-81a; 96a.)

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* The certified financial statements indicate that Takara Partners had total assets of $4,248,612 as of December 31, 1969—not $6,000,000 as stated in the write-up. Moreover, $452,343 is reported as income in the certified financial statements, representing an increase of 11.9% in 1969, not the 14.3% indicated in the write-up. Finally, the performance figure for 1970 shown in the write-up could not have come from the certified financial statements, which covered only the period up to the end of 1969. (61a; 67-81a; 161-162a.)

On October 9, 1970, the proposed retention of Yamada as one of the portfolio managers was approved by the shareholders of Competitive Associates at a meeting attended by Mr. Markizon. Shortly after the shareholders meeting, on that same day, the Board of Directors of Competitive Associates formally authorized Randolph to enter into the portfolio managers contract with Yamada. (56a; 112-113a; 121-122a; 163a; 165a.) The portfolio management contract was executed on October 12, 1970. Between June 25 and October 12, 1970, no investigation of Yamada was conducted by anyone on plaintiffs' behalf. (55a; 114a.) Yamada acted as one of the portfolio managers from October 12, 1970 through May 14, 1971, at which time he was terminated by the Board of Directors of Competitive Associates. (56-57a; 123a.)

The fact of overriding importance which was clearly established on the record below was that the certified financial statements for Takara Partners were not disseminated to either of the plaintiffs, or to any of their agents—contrary to the allegations in the complaint—and were not relied upon in any way by the plaintiffs in the hiring of Mr. Yamada as a portfolio manager. This follows from the fact that the certified financial statements of Takara Partners were not seen by any of the plaintiffs' agents until May 10, 1971, when a copy was shown to Mr. Randolph during his testimony at the SEC. At that time, Mr. Randolph testified that he had not seen the certified financial statements on any prior occasion. (58a; 146-148a.) Similarly, Mr. Markizon testified at his deposition that he had not seen the certified financial statements, that they were not presented or mentioned at the June 25, 1970 Board meeting of Competitive Associates and that no one employed by Competitive Associates or Competitive Capital had seen the certified financials prior to June 1971. (58-59a.)

Summary of Argument

Defendant-appellee LKH&H respectfully submits that:

1. The District Court properly determined that the alleged fraud upon plaintiffs was not "in connection with the purchase or sale" or "in the offer or sale" of any security by plaintiffs. The securities transactions effected by Yamada on behalf of plaintiffs occurred after the hiring of Yamada and were totally unrelated to the alleged fraud by LKH&H. Moreover, since it was established that the certified financial statements were prepared solely for and issued only to the partners of Takara Partners, a private limited partnership to which plaintiffs did not belong and in which they did not invest, LKH&H's alleged fraud could not have been in connection with the purchase or sale or in the offer or sale of securities by plaintiffs.

2. The District Court properly determined that it had been established that plaintiffs had not relied upon the financial statements certified by LKH&H, as is required for a claim under the federal securities laws in cases, as here, in which defendants are alleged to have made affirmative misrepresentations. The evidence established that plaintiffs did not see the certified financial statements until May 10, 1971 and did not rely upon them in hiring Yamada.

3. The District Court was correct in dismissing plaintiffs' state law claims of fraud and breach of fiduciary obligation. Pendent jurisdiction cannot be asserted over such claims when, as here, plaintiffs' federal claims are dismissed before trial. In addition, the evidence established that plaintiffs' state law claims are not tenable because plaintiffs did not rely on the certified financial statements.

4. The District Court was correct in granting summary judgment against plaintiffs. Facts adduced by LKH&H demonstrated that plaintiffs could not prove necessary elements of the claims alleged under the federal securities laws or under state law. Plaintiffs did not come forward with any evidence sufficient to indicate that material issues of fact remained for trial and indeed did not seek time for further discovery. Plaintiffs' assertion of hypothetical possibilities was not entitled to any weight on the summary judgment motion and did not raise any genuine issue of material fact.

ARGUMENT

POINT I

Since LKH&H's alleged fraud was not "in connection with the purchase or sale" or "in the offer or sale" of a security by plaintiffs, the federal securities law claims against LKH&H are defective.

The substance of plaintiffs' claim against LKH&H appears to be that, in reliance on the certified financial statements, plaintiffs retained Yamada as a portfolio manager—not that in reliance on the certified financial statements plaintiffs purchased or sold securities.* It is clear that, even if there were some truth to plaintiffs' claim, a fundamental element necessary to establish a cause of action under Rule 10b-5 or under Section 17(a) of the 1933 Act is lacking. Plaintiffs have not alleged or otherwise suggested that the supposed misrepresentations in the certified finan-

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* While the complaint does not adequately articulate this theory, appellant's brief attempts to correct this deficiency by concluding, following some speculation about causation, that "thus but for the acts and omissions of the accounting defendants Yamada would not have been retained by Competitive Associates nor ratified by its shareholders." (App. Br., p. 5.)

cial statements were made "in connection with the purchase or sale" or "in the offer or sale" of a security by plaintiffs, as is required under Rule 10b-5 and Section 17(a), respectively.*

To attempt to satisfy the "in connection with" requirement as to LKH&H's alleged fraud, appellant relies upon the alleged securities transactions which Yamada caused Competitive Associates to make during the time that he

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* Rule 10b-5 provides as follows:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security.*" (Emphasis added.)

Section 17(a) provides as follows:

"(a) It shall be unlawful for any person *in the offer or sale* of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly:

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit upon the purchaser." (Emphasis added.)

was a portfolio manager. (App. Br., p. 20.) These securities transactions, however, plainly do not satisfy the "in connection with" requirement as to LKH&H. It is evident that these securities transactions were entirely unrelated to LKH&H's alleged fraud and at the very most were no more than a remote consequence of that alleged fraud. There is no allegation, and certainly nothing in the record, to indicate that the financial statements were certified for the purpose of causing plaintiffs to purchase or sell securities. Viewing the allegations most favorably to plaintiffs, the certified financial statements were "disseminated" to plaintiffs and caused them to hire Yamada—but not to purchase or sell securities, which is something Yamada is alleged to have done on his own.

Nevertheless, appellant says that it meets the "in connection with" requirement under the so-called "touch" test enunciated by the Supreme Court in *Superintendent of Insurance of the State of New York* v. *Bankers Life and Casualty Co.*, 404 U.S. 6 (1971). However, in fact, there is no support whatsoever that appellant can derive from *Superintendent of Insurance* for its contention that the "in connection with" requirement is satisfied by allegations that, after the alleged fraud, a plaintiff has engaged in fortuitous and unrelated securities transactions. In *Superintendent of Insurance*, the alleged fraud was directly related to and was effectuated by means of a sale of securities, with the corporation that was issuing such securities ultimately being deprived of the proceeds of the transaction. In the present litigation, however, plaintiffs did not purchase or sell any securities in response to the purported misrepresentations in the certified financial statements—there being no claim that plaintiffs invested in Takara Partners. Plaintiffs' claim is, instead, that they were fraudulently induced to hire Yamada.

Not only is there nothing in *Superintendent of Insurance* to support appellant's position, but the cases which

have interpreted the "touch" test have rejected the contention that a subsequent adventitious purchase or sale is enough to create exposure under Rule 10b-5. Perhaps the leading case is *Landy* v. *F.D.I.C.*, 486 F.2d 139 (3d Cir. 1973), *cert. denied*, 42 U.S.L.W. 3594 (U.S. April 22, 1974). *Landy* was an action brought by four purchasers of stock of the Eatontown National Bank ("ENB"). The complaint alleged that the president of ENB, Douglas Schotte, had caused the financial collapse of the bank by speculating without proper authorization in securities belonging to the bank. Among those named as defendants were the brokerage firms which had executed the securities transactions for Schotte and the accounting firm which had prepared certain financial statements for the bank during the period in which the unauthorized trading occurred. The Court held that the brokerage and accounting firms could not properly be sued under Rule 10b-5 because plaintiffs were not persons defrauded by the firms "in connection with" the purchase or sale of securities.

One of the theories upon which plaintiffs in *Landy* relied for Rule 10b-5 standing was that they were forced sellers of ENB stock by reason of the actual or potential liquidation of the bank. The aspect of the Court's opinion dealing with the forced seller argument is directly on point here, since the liquidation of ENB by which plaintiffs in *Landy* claimed that they were forced sellers was, as here, a subsequent fortuitous sale of securities unrelated to the fraud charged. In rejecting the argument that the potential liquidation could satisfy the "in connection with" requirement, the Court stated:

> "Each of these 'forced seller' cases possesses elements not present in the case before us. . . . In each [case], the fraudulent scheme was an integral part of the forced sale and the transaction attacked. In each, the fraudulent scheme was directly related to and in connection with the forced sale. On the

> other hand, in this case, the purpose of Schotte and the brokers was not to achieve a forced sale of the bank stock. The alleged fraud of the brokers was not in connection with the putative 'forced sale' in the bank liquidation. Plaintiffs do not allege a federal securities law violation in connection with the 'forced sale' in the bank liquidation. Their complaint is directed to alleged fraud of the brokers against ENB before they became 'forced sellers' by virtue of liquidation. To the extent that they are or may become forced sellers, it is only because of internal corporate management or of possible 10b-5 fraud imposed upon ENB as a corporate entity. Under these circumstances, we do not believe the broad purpose of the Act would be served by extending standing to these plaintiffs. . . ." 486 F.2d at 159.

This holding is directly applicable in the present case. Plaintiffs do not allege that LKH&H's purpose was to cause the purchases or sales which Yamada made as portfolio manager. In other words, the alleged fraud involved in the certification of the financial statements did not touch upon, was not "in connection with" and, if you will, simply had nothing to do with the adventitious purchases or sales of securities upon which appellant relies.

Similarly, *Ingenito* v. *Bermec Corp.*, CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,548 (S.D.N.Y. 1974), is on point. In that case, plaintiffs purchased cattle from Black Watch Farms, Inc. ("Black Watch"), receiving certificates of title thereto, and simultaneously entered into a maintenance contract with Black Watch. The purchases were generally financed through promissory notes payable to Black Watch. The purchases took place in May 1969 and at other times prior thereto. Black Watch filed a bankruptcy petition in September 1970. Plaintiffs claimed they were sellers by reason of Black Watch's bankruptcy

petition and that such sales met the "in connection with" requirement of Rule 10b-5. The Court rejected plaintiffs' claim, in part on the ground that the "in connection with" requirement was not met since the alleged fraudulent concealment had no connection with Black Watch's bankruptcy nor was it for the purpose of causing it. The bankruptcy "was only the remote consequence of the eventual failure of alleged fraud in connection with the *holding* of securities, not the *occasion* for fraud in connection with a *sale*." CCH [1973-1974 Transfer Binder] at 95,893. *See Bolger* v. *Laventhol, Krekstein, Horwath & Horwath,* CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,618, at 96,192 (S.D.N.Y. 1974). In sum, the purchases and sales which Mr. Yamada may have caused Competitive Associates to make were not "in connection with" the alleged fraud of LKH&H.

Moreover, as the District Court recognized, the financial statements certified by LKH&H were issued solely to, and prepared for the benefit of, the partners of Takara Partners, a private limited partnership having only 24 partners. (68a; 80-81a.) The financial statements were not prepared for the plaintiffs or for the public generally. Nor was there any reason for LKH&H to have expected that the certified financial statements would have been relied upon or even of interest to the public generally or to anyone other than the partners of Takara Partners. In contrast to financial statements prepared for a publicly-held company, the certified financial statements for Takara Partners (1) were prepared for a limited group and for a limited purpose, (2) could not affect the market price of securities which were publicly traded and (3) were not available for public inspection since they were not filed with the SEC or with any other governmental body. The District Court, in articulating these facts and their significance, stated:

> "The pivotal fact is that the December 31, 1969 Takara Partners financial statements *were not* pre-

> pared either for plaintiffs or for the investment community in general. The LKH&H certificate on the financial statements was addressed to—and obviously prepared for—the partners of a private fund, Takara Partners. Plaintiffs have made no showing to the contrary.
>
> There is no indication of any basis for holding the accounting defendants liable to plaintiffs because of the auditing and certification of the Takara Partners financial statements for the partners of that entity. Nowhere in the complaint, or in any affidavit, or even in the briefs, is there any explanation as to how such auditing and certification could constitute conduct 'in the offer or sale' of a security to plaintiffs within the meaning of Section 17(a), or conduct 'in connection with the purchase or sale' of a security involving plaintiffs, within the meaning of Section 10(b) and Rule 10b-5. There is no indication that the accounting defendants' auditing and certification of the Takara Partners' financial statements were carried out in any way calculated to influence the investing public. . . ." (199-200a.)

There is ample authority in recent Federal cases supporting this determination of the District Court. Essentially, these cases hold that an accountant who prepares financial statements (1) for a limited number of people and for limited purposes and (2) which are not reasonably calculated to influence the investing public, is not liable to persons other than the intended recipients, even if other persons in fact see the financial statements and rely upon them. The genesis for the rule is the landmark case of *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969), in which Judge Waterman wrote:

> "Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the

> legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. . . .
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> * * * *
>
> . . . Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made . . . in a manner reasonably calculated to influence the investing public. . . ." 401 F.2d at 860, 862.

Since financial statements of the sort certified by LKH&H for Takara Partners are not "reasonably calculated to influence the investing public," the courts have uniformly held, as did the District Court here, that such financial statements do not give rise to a claim on behalf of members of the public generally, even if such persons actually see and to their detriment rely upon the financial statements.* *See Landy* v. *F.D.I.C., supra; Wessel* v.

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* As will appear from the cases discussed *infra*, the courts have found that plaintiffs who rely on financial statements which were not to be distributed to the public have failed to meet the "in connection with" a purchase or sale of securities requirement.

We believe that this may also be characterized as a finding of a lack of duty on the part of an accountant in such situations to persons other than the intended recipients of the financial statements. This concept of duty is distinct from the notion, now repudiated in the federal courts, that strict privity is required to establish a cause of action for violation of the securities laws. As the Court stated in *In re Caesars Palace Securities Litigation,* 360 F.Supp. 366, 376-377 (E.D. Pa. 1973):

> ". . . [I]t is axiomatic that some legally cognizable relationship, perhaps akin to the 'semblance of privity' concept espoused in *Joseph* v. *Farnsworth Radio & Television Corp.,* 99 F.Supp. 701, 706 (S.D.N.Y. 1951), must be present between the parties before liability may imposed. As Judge Friendly

Buhler, 437 F.2d 279 (9th Cir. 1971); *Caddell* v. *Goodbody & Co.,* CCH [1973 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 93,938 (N.D.Ala. 1972).

In *Landy* v. *F.D.I.C., supra,* the Court granted summary judgment to an accountant defendant who had prepared certain financial statements on which plaintiffs had allegedly relied in purchasing stock of the Eatontown National Bank. The decision was based, in part, on the fact that there had been no showing that the accountant knew or expected that the financial reports would be exhibited to purchasers or sellers of the bank's stock and thus the necessary relationship between any misrepresentations in the financial statements and the purchase of stock by plaintiffs was lacking. The Court explained its determination as follows:

> "Plaintiffs argue on this appeal that it was foreseeable that Burt's reports 'would be used as the basis for year-end and other periodic financial statements prepared by the management of Eatontown and distributed regularly to its shareholders'. The record, however, does not establish that Burt knew or expected that its financial reports would be exhibited to purchasers or sellers of ENB stock. The initial agreement by which Burt was engaged by the bank, dated March 4, 1968, indicated that it was to perform a 'directors examination.' There is nothing in the affidavits and testimony supporting the grant of summary judgment to indicate that Burt thought its reports would be used by anyone other than the directors. The letter agreement of hire and the nature of the services to be performed indicate

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has intimated in *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 867 (2d Cir. 1968) (concurring opinion), if this underlying concept of privity was totally disregarded, a burden out of all proportion to the fault involved might be cast upon anyone who makes false assertions in the marketplace. . . ."

> that Burt essentially was to make spot checks at the bank to inform the directors of the presence, if any, of irregularities. The conclusion that Burt did not expect them to be used in connection with the purchase or sale of ENB stock is reinforced because the record does not establish that Burt's figures actually were used in the bank's annual reports or its published financial statements, or exhibited to any of the plaintiffs, except Landy.
>
> None of the directors' reports was made in a manner reasonably calculated to influence the investing public. There is no proof that any were disseminated to the public or that any investor saw them except for Landy, a director and counsel for the bank. Burt delivered the reports to the bank directors for uses unconnected with stock issuance and there is no proof that anyone else saw them. We decline to extend rule 10b-5 to cover Burt's statements by finding them 'in connection with the purchase or sale of any security.' " 486 F.2d at 168 (footnotes omitted).

In *Wessel* v. *Buhler*, *supra*, the Court affirmed the grant of a directed verdict in favor of an accountant defendant. Figures from a financial statement prepared by the accountant defendant appeared in a prospectus that, according to plaintiffs, contained material misrepresentations. Noting that the financial statements had been prepared by the accountant for uses unconnected with the stock issuance in question, the Court held that therefore the accountant could not be found liable under Section 10(b) or Rule 10b-5.

> ". . . [W]e assume that all three financial statements were misleading. Despite that assumption, no liability under Rule 10b-5 could have been based on those statements because there was no proof that

the statements alone were statements 'in connection with the purchase or sale of any security.'

The quoted phrase has been broadly construed to effectuate Congress' intent to prevent corporate practices that are reasonably likely to mislead investors to their detriment. . . .

None of the three financial statements was made 'in a manner reasonably calculated to influence the investing public.' None was publicly disseminated in any way. There was no evidence that any investor ever saw the statements until after the litigation began. The evidence was that Jordan delivered them to the Board for uses unconnected with stock issuance, and, as far as the evidence discloses, no one before suit ever saw them, except the officers and directors of RMC and the agencies to which they were directed. We decline to stretch Rule 10b-5 to cover Jordan's financial statements. . . ." 437 F.2d at 281-282.

In *Caddell* v. *Goodbody & Co., supra,* the Court similarly rejected an attempt to assert liability against accountants. In that case the accountant defendant had certified the inaccurate financials of a company ("Goodbody") which had negotiated an exchange of securities. Pursuant to the exchange, plaintiff sold stock to Florida Capital Corporation, of which Goodbody was a major stockholder. In granting the motion of the defendant accountant for summary judgment, the Court focused on the fact that the alleged misrepresentations in the financial statements did not relate to the company to which stock was sold, but rather related only to Goodbody.

". . . [S]ome courts have extended liability by expanding the class of persons who the auditor should know may rely on his statements. The rationale for such extension is that when an accountant

> prepares a financial statement for filing with the SEC or an exchange, he acts as an independent auditor and must know that such statements are used and relied upon by the investing public. . . . Although the alleged factual situations and theories of liability varied, every case cited involved misrepresentations as to the net worth of the companies involved and transactions in the shares of the company about which the financial statement was made. . . .
>
> The plaintiffs here urge that this problem may be cured by a broad interpretation of the phrase 'in connection with' of Rule 10b(5) and cite *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), and *Heit* v. *Weitzen*, 402 F.2d 909 (2d Cir. 1968), in support of that position. There is nothing in those decisions to indicate that misstatements about one company's financial condition will create liability for a loss from a sale or purchase of another corporation's securities. It is, in fact, a broad interpretation of 'in connection with' to hold that financial statements made at regular intervals and not specifically for promoting stock sales are 'in connection with' every sale of securities to a private investor who alleges that he read and relied on such a statement." CCH [1973 Transfer Binder] *Fed. Sec. L. Rep.* at 93,739-93,740.

Appellant's Conspiracy Theory

Apparently recognizing the impediment which the foregoing cases pose to its attempt to establish liability over the accounting defendants,* appellant in its brief apparently

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* While plaintiffs below and appellant here have not strenuously pressed their purported claim under the Investment Advisors Act, appellant does mention that claim at the conclusion of its brief. (App. Br., pp. 24-25.) Even if there were a private right of action for damages under the Advisors Act, which we dispute, it is plain

charges that a conspiracy existed between LKH&H and Yamada to misappropriate plaintiffs' assets. For instance, appellant's brief contains the following conspiracy language: (1) "With the *knowing aid and participation of the accounting defendants,* Yamada enticed investment advisory clients by falsely inflating the performance of his showcase investment partnership, Takara Partners"; (2) "The indispensable element in . . . [Yamada's] scheme, *which the accounting defendants unlawfully facilitated,* was the manipulation of securities prices and the sale of these securities to investors attracted by Yamada's false reputation and performance"; and (3) "The district court there made a fact finding on the intent of the *conspirators* (*Yamada and the accounting defendants*) and on their purposes in falsifying the financial statements, matters hotly contested in this action." (App. Br., pp. 20-21.)

Appellant's brief is replete with this type of conclusory assertion—for which references to the record are totally absent. We presume that the reason for these [illegible]lated conspiracy charges is appellant's hope of showing that Yamada's portfolio management activities were "in connection with" the purchase or sale of securities by plaintiffs, for which purchases or sales they would like to hold LKH&H responsible through a conspiracy.

Appellant's effort should be recognized for what it is—a mere afterthought lacking in substance—and rejected. First, plaintiffs did not plead in their complaint any conspiracy of the type that is now suggested by appellant's attorneys. While the first count of the complaint does con-

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that there are no allegations against the accounting defendants which could state a claim as to them under §§ 206(1) or (2) of that Act since, as the District Court noted, there were no acts by the accounting defendants "directed to plaintiffs." (200a.) Here, too, appellant attempts to overcome the deficiency with broad charges of conspiracy. As is shown below, that theory is insubstantial. Moreover, plaintiffs' established lack of reliance is as fatal to their Advisors Act claim as it is to their other claims. *See* Point II *infra.*

tain the phrase "in concert," it deals solely with concerted action causing the dissemination of the certified financial statements to plaintiffs and not with the much broader conspiracy proposed on this appeal. (16a.) Moreover, the first count is alleged in the barest conclusory terms and, accordingly, is violative of Fed. R. Civ. P. 9(b). *See Passerieux* v. *Time, Inc.*, CCH [Current Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,805, at 96,680 (S.D.N.Y. 1974); *Sloan* v. *Canadian Javelin, Ltd.*, CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,579, at 96,033 (S.D.N.Y. 1974); *Felton* v. *Walston and Co., Inc.*, CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,490, at 95,715 (S.D.N.Y. 1974); *Zammas* v. *Jagid*, CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,342, at 95,156-95,157 (S.D.N.Y. 1973); *Washburn* v. *Madison Square Garden Corp.*, 340 F. Supp. 504, 507-508 (S.D.N.Y. 1972). Finally, and we believe most important, there is nothing in the record—and in particular, no evidentiary showing tendered in opposition to the motion below—which even begins to suggest that there is substance to the conspiracy theory.

In sum, there is no basis for the contention that the financial statements certified by LKH&H were related to any purchase or sale of securities by plaintiffs. Accordingly, the determination of the District Court that the accounting defendants could not be liable to plaintiffs as a result of any misrepresentations in such financial statements should be affirmed.

POINT II

Upon the record here, the District Court correctly determined that Yamada had not been hired in reliance on financial statements certified by LKH&H and, accordingly, plaintiffs' federal claims against the accounting defendants were properly dismissed.

The District Court found, on the basis of the evidence before it on the summary judgment motion, that neither of the plaintiffs saw the certified financial statements until May 10, 1971, when Mr. Randolph was shown a copy thereof during his SEC testimony. (194-195a.) Accordingly, the complaint was dismissed as to the accounting defendants for lack of a showing of reliance. Appellant contends that this was erroneous for two reasons. First, appellant contends that, as a matter of law, reliance is not an essential element of its claim. Second, appellant argues that the District Court's finding that lack of reliance had been established is incorrect essentially for two reasons: (1) LKH&H did not negate the possibility that "Randolph, any director, any adviser to the board of directors, or any shareholder of Competitive Associates . . . may have seen" (App. Br., p. 14) the certified financial statements; and (2) the finding that plaintiffs did not see the certified financial statements was dependent in large part on the SEC testimony of Mr. Randolph, which, according to appellant, should not have been considered on a summary judgment motion. All of plaintiffs' arguments are without merit.

A) Reliance Is An Essential Element of Plaintiffs' Case

Appellant's principal contention is that reliance is not an essential element of its claim against the accounting defendants and that all it need show is "causation-in-fact" (App. Br., p. 6), by which appellant apparently means that it is entitled to damages if it can prove that "but for" the alleged misrepresentations in the financial statements cer-

tified by LKH&H, appellant would not have been injured. For this contention, appellant relies on *Affiliated Ute Citizens of Utah* v. *United States,* 406 U.S. 128 (1972) and *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith,* 495 F.2d 228 (2d Cir. 1974). Upon the facts here, these cases are inapposite. They stand only for the proposition that proof of reliance is unnecessary in cases involving nondisclosure, that is, in cases in which the defendant has a duty to speak but does not. Plainly, it continues to be the law in this Circuit, and apparently in all others, that in cases involving allegations of misrepresentation, or allegations of omissions combined with misrepresentations, reliance is an essential element. *Schlick* v. *Penn-Dixie Cement Corp.,* — F.2d — (2d Cir. 1974); *Raschio* v. *Sinclair,* 486 F.2d 1029 (9th Cir. 1973); *Landy* v. *F.D.I.C., supra; Booth* v. *Anaconda Co.,* CCH [1973-1974 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,106 (N.D. Ill. 1973).

As the Court of Appeals for the Second Circuit has very recently stated in *Schlick, supra:*

> "This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both *loss causation*—that the misrepresentations or omissions caused the economic harm—and *transaction* causation—that the violations in question caused the appellant to engage in the transaction in question.
>
> The former is demonstrated rather easily by proof of some form of economic damage, here the unfair exchange ratio, which arguably would have been fairer had the basis for valuation been disclosed. Transaction causation requires substantially more. In a misrepresentation case, to show transaction causation a plaintiff must demonstrate

> that he relied on the misrepresentations in question when he entered into the transaction which caused him harm. . . ." *N.Y.L.J.*, Nov. 4, 1974, at 6 (footnote omitted).

Similarly, in *Landy* v. *F.D.I.C., supra,* the Court of Appeals for the Third Circuit held, as an alternative basis for its decision, that plaintiffs' lack of reliance was fatal to their claim. The Court stated:

> "The second reason justifying the entry of summary judgment against Gloria Landy, Harry Gross, and Freehold Glass is the absence of evidence that they relied on any of Burt's reports. To an extent, the reliance requirement is similar to the 'in connection with' requirement. It differs by focusing on the state of mind of the victim of the fraud rather than the perpetrator.
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> * * * *
>
> The depositions in this case revealed that none of the plaintiffs except for Landy ever saw any of the reports prepared by Burt. They have therefore failed to support their allegation of an essential element of their cause of action under rule 10b-5. Since Burt's reports to the directors were not prepared for or disseminated to the public or the stockholders, the presumption of reliance sometimes used in other circumstances when a statement is material is inapplicable here. . . ." 486 F.2d at 170.

The essential question, then, is whether this is a nondisclosure case as appellant asserts. (App. Br., p. 6.) We submit that if there ever was a case involving allegations of misrepresentation, as opposed to nondisclosure, this is it. A review of the allegations of the complaint concerning the certified financial statements unquestionably reveals that representations concerning net income, unre-

alized profit, current assets, current liabilities and other matters contained in the certified financial statements are alleged to have been affirmatively false. (14a.) While we recognize that it is also alleged that certain matters were not disclosed in the certified financial statements, in virtually every case of alleged affirmative misrepresentation there is an express or implicit allegation of a failure to disclose the true facts. Despite the presence of that allegation, such cases are misrepresentation cases requiring reliance.

B) Absence of Reliance by the Plaintiffs

Upon the record here, the District Court determined that it had been established that plaintiffs had not seen the financial statements certified by LKH&H until May 10, 1971, and had not relied upon them in hiring Yamada. (194a.) The evidence supporting this determination is not only overwhelming, but also wholly undisputed. Nevertheless, appellant challenges the finding, arguing that the burden was on the accounting defendants to negate the possibility that any one of a class alleged to consist of "several hundred" people—"Jerome Randolph, any director, any adviser to the board of directors, or any shareholder of Competitive Associates" (App. Br., p. 14)—might have seen the financial statements in question. Appellant's argument, however, is pure conjecture and—as is demonstrated in Point IV, *infra*—is insufficient to prevent the grant of summary judgment against plaintiffs. Appellant failed to produce the sworn statement of even one member of the class of persons who it suggests might have seen the certified financial statements.* There is nothing

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* Appellant claims that, as part of his investigation, Randolph interviewed "at least one limited partner of Takara Partners." (App. Br., p. 4.) The only possible source of support in the record for this assertion is the purported list of the partners of Takara Partners, which states that Yamada—whom for the purposes of the motion we concede Randolph did interview—was himself a limited as well as a general partner. (99a.)

in the record indicating that any such person actually did see those statements, that he relied on such financial statements or that, as a result, the financial statements somehow contributed to plaintiffs' hiring of Yamada.

In contrast to appellant's speculations, Mr. Lesch set forth at length in his affidavits the relevant excerpts and transcript references from the deposition testimony of Mr. Markizon, plaintiffs' secretary, and from the testimony before the SEC of Mr. Randolph, the president of both plaintiffs. Such testimony established (1) that Mr. Randolph was the only individual who took part on behalf of plaintiffs in the screening and recommending of portfolio managers and was the only individual who, on their behalf, saw the financial statements certified by LKH&H * and (2) that Mr. Randolph in fact did not see such financial statements until the day of his testimony before the SEC on May 10, 1971.**

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* There is no support in the record for the implication that others took part in the screening of portfolio managers or that Mr. Randolph conducted merely "the bulk" of the investigation or that the investigation was conducted only "primarily" by Mr. Randolph. (App. Br., pp. 4, 13.) Mr. Randolph did not indicate that anyone other than himself participated in the process of selecting new portfolio managers. (139-148a.) Mr. Markizon's testimony was even more definitive:

> "Q. Was there anyone other than Mr. Randolph who did any work whatsoever in connection with retaining Mr. Yamada or his firm, Takara Asset Management Corporation?
> A. No." (60a.)

** The testimony of Mr. Randolph before the SEC was as follows:

> "Q. I will show you a document which has previously been marked as Yamada Exhibit No. 24 as of May 5, 1971.
>
> Have you ever seen that document?
>
> For the record, I think on some occasions the first five or seven pages of this have been circulated separately. We are not certain of the back-up materials.
> A. I have not seen that.

Moreover, it is clear from the record that the certified financial statements were not exhibited nor was the name of LKH&H even mentioned at a single Competitive Associates directors meeting prior to or even during the time that Mr. Yamada was appellant's portfolio manager. (55-59a, 141a, 144a, 161-187a.) Mr. Markizon testified that, at the Competitive Associates board meeting of June 25, 1970 at which Mr. Yamada's retention was approved, the only financial information concerning Takara Partners that was presented was that contained in the write-up prepared by Randolph, which Randolph had extracted from the June 12, 1970 letter from Yamada. (109-111a.)

Plainly, having adduced the foregoing undisputed testimony, it was not incumbent upon LKH&H to produce sworn statements from all of the several hundred people suggested by appellant's attorneys.

Q. Well, review it and then make a statement on it.

MR. GREEN: Let's go off the record.

(Discussion off the record.)

MR. RODE: On the record.

THE WITNESS: I have not seen that document.

MR. RODE: That is Yamada Exhibit No. 24 of May 5, 1971, which is the '69 year-end statement for Takara Partners.

By Mr. Rode:

Q. Did you see anything comparable, any kind of a balance sheet?

A. No." (148a.)

Mr. Markizon's testimony was consistent with that of Mr. Randolph.

"Q. To your knowledge, did anyone at Competitive Associates see the financial statements for Takara Partners prior to June 1971?

A. Not to my knowledge.

* * *

Q. Did anyone employed by or associated with Competitive Capital see the financial statements for Takara Partners prior to June 1971?

A. Not to my knowledge." (59a.)

C) Propriety of the District Court's Consideration of the Randolph Testimony

Appellant contends that it was improper for the District Court to have considered Mr. Randolph's SEC testimony and argues that such testimony was "the cornerstone, the only cornerstone, upon which summary judgment was built." (App. Br., p. 17.) The answer to this contention is that (1) the deposition testimony of Mr. Markizon referred to above was in itself sufficient evidence—plaintiffs having offered nothing at all to the contrary—that plaintiffs had not seen the certified financial statements at any relevant time and (2) the Randolph testimony was indeed properly open to consideration by the District Court upon the motion.

Appellant raises several evidentiary objections to the Randolph testimony. First, appellant argues that the testimony was not authenticated.* This is an objection which plaintiffs did not raise in the District Court and which was therefore waived. *Sprogis* v. *United Air Lines, Inc.*, 444 F.2d 1194, 1200 n. 8 (7th Cir.), *cert. denied*, 404 U.S. 991 (1971); *Noblett* v. *General Electric Credit Corp.*, 400 F.2d 442, 445 (10th Cir.), *cert. denied*, 393 U.S. 935 (1968); *Auto Drive-Away Co. of Hialeah* v. *Interstate Commerce Commission*, 360 F.2d 446, 448-449 (5th Cir. 1966). The reason for the waiver rule is evident: if such objections were not waived unless asserted at the time of the summary judgment motion, the party desiring to use a testimonial transcript would, in essence, be required to anticipate every conceivable technical objection which an opposing party might raise on appeal. This is not required, as the Court

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* Appellant combines several objections under this rubric, including that there was no indication that Randolph had been sworn, no indication that he had signed the transcript, no indication of the interrogator, and no indication of the reporter or qualifications of the reporter. (App. Br., p. 16.)

of Appeals for the Fifth Circuit clearly stated in the *Auto Drive-Away* case, *supra,* at 448-449 (footnote omitted):

> "The defendants made no attempt to contradict these facts. They concede that the sole issue is the sufficiency of evidence to support the summary judgment. They do not dispute that the ICC affidavit, party admissions on file, and other materials together contain sufficient evidence to prove that their operation requires ICC authorization. . . . The defendants instead attack the admissibility of most of the materials on which the court based its judgment. They complain that the ICC investigator's affidavit does not clearly show his competence to testify and that unsworn exhibits accompanied his statement. These objections come too late: the defendants failed to object to the introduction or use of the affidavit and exhibits below. An affidavit that does not measure up to the standards of Rule 56(e) is subject to a timely motion to strike. In the absence of this motion or other objection, formal defects in the affidavit ordinarily are waived. United States, for Use and Benefit of Austin v. Western Electric Co., 9 Cir. 1964, 337 F.2d 568; Klingman v. National Indemnity Co., 7 Cir. 1963, 317 F.2d 850; 6 Moore, Federal Practice ¶ 56.22 [1] & n. 49 (2d ed. 1965)."

It should also be noted that, aside from waiving this objection, appellant has failed to refer to anything in the record indicating that there is any substance underlying its objection to the authentication of the testimony.

Second, appellant objects that the Randolph testimony was incomplete in that the entire transcript was not submitted to the District Court. Surely, however, plaintiffs possessed a copy of the entire Randolph transcript and had ample opportunity to present any portions of the transcript which they felt bolstered their case or related to the matters at issue; indeed, in their papers upon the

motion (93-94a), they did bring to the District Court's attention material on page 33 of the transcript. Moreover, in quoting excerpts from the testimony of Messrs. Markizon and Randolph, Mr. Lesch specifically made the following offer: "Should there be any dispute as to the accuracy of such references or should the Court request copies of the relevant underlying documents, they will be furnished to the Court." (54a.) Finally, there obviously is no rule precluding a party from adducing on a summary judgment motion only portions of a transcript.

Third, appellant argues that the Randolph testimony was hearsay and that there was no exception to the hearsay rule applicable. Appellant's objection ignores the undisputed fact that Randolph was president of both plaintiff corporations at the time the testimony was taken. (36a; 137a.) Hence, the testimony constituted an admission. *See Mackay* v. *American Potash & Chemical Co.*, 268 F.2d 512 (9th Cir. 1959).

Moreover, appellant's objection misconstrues Fed. R. Civ. P. 56(e), which sets forth what can be adduced on a summary judgment motion. Rule 56(e) provides that sworn statements made on personal knowledge and containing facts admissible at trial may be submitted on a summary judgment motion as long as the affiant in each case is competent to testify as to the facts set forth in his or her sworn statement. Obviously, there is no requirement that the sworn statement itself, as contrasted to the facts contained therein, be admissible; affidavits, though not themselves admissible in evidence, can be used on a summary judgment motion, according to Rule 56(e). Here, Mr. Randolph's SEC testimony was a sworn statement containing facts about which Mr. Randolph unquestionably would be competent to testify at trial and which would be admissible in evidence. Thus, the testimony of Mr. Randolph was appropriate for consideration under Rule 56(e). *See Noth* v. *Scheurer*, 285 F. Supp. 81, 83 (E.D.N.Y. 1968). The

cross-examination problem which troubles appellant is, of course, present with any affidavit submitted by a party on a summary judgment motion and is no impediment to the use of the affidavit on a summary judgment motion. *See Banco de Espana* v. *Federal Reserve Bank*, 114 F.2d 438, 445 (2d Cir. 1940). Furthermore, if plaintiffs had really felt they were handicapped by the absence of cross-examination,* they should at least have invoked the protection of Fed. R. Civ. P. 56(f), which plaintiffs did not do. Under Rule 56(f), plaintiffs could have obtained a continuance of the motion in order to conduct the deposition of Mr. Randolph.**

Blum v. *Campbell*, 355 F.Supp. 1220 (D. Md. 1972), upon which appellant relies for its argument that the Randolph SEC testimony should not have been considered, not only fails to support that argument, but is further authority for the argument in Point IV, *infra*, that plaintiffs here failed to make the necessary showing to prevent summary judgment. In the *Blum* case, the party moving for summary judgment objected strenuously to the district court about the technical deficiencies of the "deposition", something which the plaintiffs did not do in the present litigation. Second, the deposition in *Blum* obviously was not an admission, contrary to the situation here. And third, the party in *Blum* opposing the use of the deposition

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* It should be noted that Philip N. Smith, Jr., Esq., did accompany Randolph at his testimony before the SEC and that the record indicates that "Mr. Smith represented Mr. Randolph and the Fund at the proceeding." (182a.)

** There is no support in the record for the assertion made by appellant in its brief (App. Br., p. 14) that "Randolph's specific whereabouts were not known to Competitive Associates" at the time of the summary judgment motion. Moreover, the implication that it was impossible for appellant to locate Randolph is not only without support in the record but apparently disingenuous, since if Randolph was being sued by Competitive Associates in the federal court in California—as appellant states (App. Br., p. 14)—then surely he could be located.

presented *facts* to the district court showing that there was substance to his objections, something which appellant has wholly failed to do in this case. Consequently, it is clear that *Blum* can be of no use to appellant.

Accordingly, we submit that, on the basis of the record, the District Court was compelled to find—as it did—that the plaintiffs had not seen the certified financial statements and did not rely upon them in hiring Yamada.

D) Appellant's Failure to Establish Causation

Appellant contends that reliance is not an essential element of its claim and that it need only establish "causation-in-fact." (App. Br., p. 6.) Even if this were so, there are no facts in the record to support appellant's contention that such causation existed with reference to the damages that plaintiffs claim to have incurred here.

The classic statement in this Circuit upon the subject of causation is contained in *Globus* v. *Law Research Service, Inc.*, 418 F.2d 1276, 1291 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970), in which the Court of Appeals approved the following instruction by the trial court to the jury:

> "[T]he plaintiff is required to prove by a fair preponderance of the evidence that he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance to them. In other words, the plaintiff must show that the misleading statement or omission played a substantial part in bringing about or causing the damage suffered by him or her and that the damage was either a direct result or a reasonably foreseeable result of the misleading statement."

In its attempt to establish causation in accordance with the above instruction, while at the same time avoiding the necessity of proving reliance, appellant has belatedly

asserted a far-fetched theory entirely different from the claim made in the complaint. In the complaint, plaintiffs alleged that they themselves actually received—and relied upon—financial statements certified by LKH&H. (13a; 16a.) In its brief, on the other hand, appellant propounds a theory based on the assertion that if the financial statements had been accurate, they would have disclosed the allegedly poor performance of Takara Partners, and the partnership . . .

> "would not have retained its blue-ribbon membership and Yamada would have been regarded as an investment advisory failure. Thus but for the acts and omissions of the accounting defendants Yamada would not have been retained by Competitive Associates, nor ratified by its shareholders. In addition had the accounting defendants made the necessary disclosures in the later months of 1970 or early months of 1971 Competitive Associates would have terminated the advisory contract immediately." (App. Br., p. 5.)

Among the problems with such a theory, as the District Court observed, is that ". . . plaintiffs have not come forward with the slightest factual support for it. The theory is presented in the barest conclusory fashion in a memorandum of law." (198a.) There is simply nothing in the record, nor even in the allegations of the complaint, indicating (1) who the investors in Takara Partners were, (2) that such investors were especially wealthy or well-known, (3) that Takara Partners would have terminated Mr. Yamada if the financial statements certified by LKH&H had disclosed the true performance of the partnership or (4) that if such financial statements had been accurate, Mr. Yamada would have been regarded by anyone as an investment advisory failure. There is simply no factual support for even a single link in plaintiffs' causation theory, much less for the theory as a whole.

There is not one sworn statement from any limited or general partner of Takara Partners or even from one officer, director or shareholder of either plaintiff. Plaintiffs below, and appellant here, have merely spun a vacuous chimera.

Moreover, the failure of plaintiffs to state this causation theory with specificity in the complaint renders the complaint subject to dismissal.

> "Because allegations of fraud made against accountants and others whose business depends on clients' trust and confidence can threaten their entire professional status, Rule 9(b) requires that plaintiffs set forth more completely than in an ordinary complaint the factual circumstances that allegedly entitle them to relief. . . .
>
> In light of the standards of Rule 9(b), the amended complaint of December 29, 1973 lacks the required specificity, such as with respect to whether plaintiff relied on the alleged false and misleading statements and reports, whether the alleged fraudulent statements were made in connection with a purchase or sale of a security by him and whether the injuries of which plaintiff complains were caused in fact by defendants' alleged fraudulent activities . . . ." *Sloan* v. *Canadian Javelin, Ltd., supra,* at 96,033.

Accord, Passerieux v. *Time, Inc., supra; Felton* v. *Walston & Co., Inc., supra; Zammas* v. *Jagid, supra; Washburn* v. *Madison Square Garden Corp., supra. See generally Segal* v. *Gordon,* 467 F.2d 602 (2d Cir. 1972); *Shemtob* v. *Shearson Hammill & Co.,* 448 F.2d 442 (2d Cir. 1971).

Accordingly, we submit that appellant's causation theory should be disregarded upon this appeal.

POINT III

Plaintiffs' state law claims against the accounting defendants should also be dismissed because the Court lacks pendent jurisdiction thereover and because the undisputed facts demonstrate that such claims are fatally defective as a matter of state law.

Maintenance in the present action of plaintiffs' state law claims of fraud and breach of fiduciary obligation is predicated solely upon "the principles of pendent jurisdiction." (11a.) As has been shown hereinabove (Points I and II, *supra*), LKH&H is entitled to summary judgment dismissing plaintiffs' claims arising under the federal securities laws. Since such federal claims cannot be maintained, the claims allegedly arising under state law must be dismissed as well. It is well settled that where plaintiffs' "federal claims are dismissed before trial, even though not insubstantial in a jurisdictional sense, the state claims should be dismissed as well." *United Mine Workers* v. *Gibbs*, 383 U.S. 715, 726 (1966) (footnote omitted). *Accord, Calderone Enterprises Corp.* v. *United Artists Theatre Circuit, Inc.*, 454 F.2d 1292, 1297 (2d Cir. 1971), *cert. denied*, 406 U.S. 930 (1972).

Moreover, the state law claims asserted by plaintiffs are fatally defective for reasons set forth in Point II, *supra*. Thus, it is clear that reliance is one of the elements that must be proved to establish common law fraud. *Jo Ann Homes* v. *Dworetz*, 25 N.Y.2d 112, 119 (1969); *Matthews* v. *Schusheim*, 42 A.D. 2d 217, 221, 346 N.Y.S.2d 386, 391 (2d Dep't 1973); *Terris* v. *Cummiskey*, 11 A.D.2d 259, 260-261, 203 N.Y.S.2d 445, 446-448 (3d Dep't 1960). In the present case, the record reveals that plaintiffs did not see the certified financial statements until well after the employment of Yamada had taken place and also that the accounting defendants owed no fiduciary duty to plaintiffs, who were strangers to them. Accord-

ingly, no cause of action for fraud or for breach of fiduciary duty can be based on the alleged misrepresentations in such financial statements. *See Miller* v. *Greyvan Lines*, 284 A.D. 133, 130 N.Y.S.2d 378 (4th Dep't 1954); *aff'd*, 308 N.Y. 853 (1955); *Ultramares Corp.* v. *Touche*, 255 N.Y. 170 (1931); *Kaydee Sales Corp.* v. *Feldman*, 14 Misc. 2d 793, 184 N.Y.S. 2d 151 (S.Ct. Monroe Co. 1958).

POINT IV

Plaintiffs did not introduce any evidence in opposition to the facts adduced by LKH&H upon the motion for summary judgment; accordingly, upon the record here, dismissal of the complaint as to the accounting defendants was mandated.

Points I, JI and III, *supra*, have been devoted largely to a rebuttal of the legal theories proposed by appellant's attorneys. A more basic reason for rejecting those theories and for awarding summary judgment is that not the slightest factual support appears in the record for any of the theories. Instead, as the District Court emphasized in its Opinion (196-197a), plaintiffs have relied solely upon hypothetical possibilities—suggesting things which people *may have* done, or *may have* known, or *may have* seen. Having postulated these hypotheses, plaintiffs in the District Court, and appellant here, have argued that LKH&H did not meet its burden since it did not negate all of the suggested possibilities. We submit that appellant misconstrues the principles governing summary judgment under Fed. R. Civ. P. 56 and the relative burdens which those principles place upon the parties. We believe that a proper application of such principles compelled the District Court's findings here and furthermore that appellant's theories—having no support in the record—must be rejected.

Of course, appellant is correct in asserting that, on a motion for summary judgment, "[t]he burden of showing

an absence of any material factual issue is on the moving party. . . ." (App. Br., p. 12.) But the overwhelming evidence submitted by defendant LKH&H clearly placed upon plaintiffs the burden of coming forward with evidential material—not just theories or speculation—sufficient to indicate that material issues of fact remained for trial. While we do not see how there can be much dispute as to this principle, in view of appellant's attempt to place exaggerated burdens on LKH&H we believe it is appropriate to review the law.

Rule 56(e) of the Federal Rules of Civil Procedure provides, in relevant part:

> ". . . When a motion for summary judgment is made and supported as provided in this rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him."

As the Court recently stated in *Strother* v. *Great Notch Corp.*, 57 F.R.D. 113, 118-119 (D.N.J. 1972):

> ". . . [W]hen a movant comes forward with facts showing that his adversary's case is without merit, the party against whom the motion is made cannot simply rest upon the allegations of the complaint but in turn must adduce factual material 'which raises a substantial question of the veracity or completeness of the movant's showing or presents countervailing facts. . . .'"

Accord, *Beal* v. *Lindsay*, 468 F.2d 287, 291 (2d Cir. 1972); *Donnelly* v. *Guion*, 467 F.2d 290, 293-294 (2d Cir. 1972); *Robin Construction Co.* v. *U.S.*, 345 F.2d 610, 613-14 (3d Cir. 1965).

The Court below, in commenting on and rejecting plaintiffs' non-evidentiary opposition to the summary judgment motion, stated:

> "Plaintiffs' contentions on this motion are without substance. Plaintiffs suggest that Randolph *may have* done more in his investigation of Yamada than is shown by his SEC testimony. Plaintiffs suggest the possibility that two former directors of Competitive Associates—Richard Boisel and Robert Sprinkel —*may have* known Yamada. Plaintiffs state that it is not known whether Boisel or Sprinkel *may have* seen the audited financial statements of Takara Partners. Plaintiffs suggest that there *may have been* some mention of LKH&H at the Competitive Associates board meetings of June 25, 1970 and October 9, 1970, although the minutes do not reflect, nor does Markizon recall, anything of the kind. Finally, plaintiffs point out that depositions have not been taken of some or all of the people who might have knowledge regarding these possible theories.
>
> Clearly, this posing of hypothetically possible theories on which the accounting defendants might be responsible to plaintiffs is not sufficient to withstand a summary judgment motion. . . ." (196-197a).

It is noteworthy that the tactic which plaintiffs use here —arguing that some as yet undeposed witness might testify as to a version of the facts different from all the testimony to date—was condemned in a recent case involving plaintiffs and arising out of the alleged misdeeds of Mr. Yamada. *Competitive Associates, Inc.* v. *Children's World, Inc.*, CCH [1973 Transfer Binder] *Fed. Sec. L. Rep.* ¶ 94,-063 (S.D.N.Y. 1973), involved an action brought by plaintiffs to recover damages from Children's World, Inc. and certain other defendants who participated in that company's issuance of stock. Although the Court denied defendants' summary judgment motion because of defen-

dants' insufficient showing, the Court nevertheless observed with respect to plaintiffs:

> ". . . Were the affidavits the slightest bit competent or credible, this Court would not hesitate to grant the motion for summary judgment dismissing the complaint as against the moving defendants in view of the fact that counsel for plaintiffs failed to put these defendants' liability in issue. Although plaintiffs stated several times that they had not yet deposed the Children's World directors, they did not give any reason for not having done so. 'A party must either controvert the supporting affidavits or explain why it cannot present its version of the facts. Any other rule would frustrate the objective of Rule 56.' *Belinsky* v. *Twentieth Restaurant, Inc.*, 207 F. Supp. 412, 413 (S.D.N.Y. 1962). . . ." CCH [1973 Transfer Binder] *Fed. Sec. L. Rep.* at 94, 274.

Here, not only did plaintiffs fail to controvert the facts adduced by LKH&H, but plaintiffs did not even offer a justification as to why they have been unable to support the version of the facts which their attorneys convey. Plaintiffs significantly did not even seek to invoke the provisions of Fed. R. Civ. P. 56(f), which provides:

> "*When Affidavits are Unavailable.* Should it appear from the affidavits of a party opposing the motion that he cannot for reasons stated present by affidavit facts essential to justify his opposition, the court may refuse the application for judgment or may order a continuance to permit affidavits to be obtained or depositions to be taken or discovery to be had or may make such other order as is just."

This is not the first time that a plaintiff has attempted—and failed—to defeat summary judgment by citing speculative uncertainties and at the same time failing to invoke

the provisions of Rule 56(f). In *Robin Construction Company* v. *United States, supra,* the Court upheld summary judgment and stated:

> "The purpose of summary judgment would be defeated if a party who has obtained by discovery and from affidavits information which he should seek to amplify or test by further discovery, merely rests on a statement of ignorance of the facts. Indeed, subdivision (f) of Rule 56, by affording an opportunity for continuance of an application for summary judgment so as to permit affidavits to be obtained or depositions to be taken or discovery to be had, indicates that absent such effort it is idle to attempt to shrug off the facts which his adversary has presented. As has often been pointed out, one who resists summary judgment but does not contradict the operative facts in his adversary's affidavit must utilize discovery, and suspicion alone without discovery is not enough. See Schneider v. McKesson & Robbins, Incorporated, 254 F.2d 827 (2 Cir. 1958). It is true that Rule 56(f) also authorizes the court in appropriate cases to refuse to enter summary judgment where the party opposing the motion shows a legitimate basis for his inability to present by affidavit the facts essential to justify his opposition; but to take advantage of this provision he must state by affidavit the reasons for his inability to do so and these reasons must be genuine and convincing to the court rather than merely colorable. It is not enough to rest upon the uncertainty which broods over all human affairs or to pose philosophic doubts regarding the conclusiveness of evidentiary facts. In the world of speculation such doubts have an honored place, but in the daily affairs of mankind and the intensely practical business of litigation they are put aside as conjectural. . . ." 345 F.2d at 613-614.

And as stated in *Strother* v. *Great Notch Corporation*, *supra*:

> "... Plaintiff has not even seen fit to take advantage of the 'safety valve' of subdivision (f) which enables one to present by affidavits 'reasons ... [why he cannot present by affidavit] facts essential to justify his opposition ... [to the motion].' Accordingly for the reasons stated, defendants' motion for summary judgment is granted, and it is so ordered and adjudged, with costs." 57 F.R.D. at 120.

Consequently, under long-standing summary judgment principles, dismissal of the complaint as to the accounting defendants was fully warranted.

CONCLUSION

For the reasons set forth herein, the determination of the District Court should be affirmed in all respects.

Respectfully submitted,

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